Class 12

Business Studies

Chapter 9

Financial Management

Ajith Kanthi Wayanad
www.hssplustwo.blogspot.com

FINANCIAL MANAGEMENT

Finance refers to money, cash or fund available to carry out business operations

Finance is the life blood of business

A business enterprise requires funds at different stages - to start a business, to operate and to expand

FINANCIAL MANAGEMENT

Financial management is considered to be the management of finance function

It deals with planning, organizing, directing and controlling financial activities like procurement and utilization of funds and distribution of earnings to owners

Role and Importance of Financial Management

Importance of Financial Management

a Size and composition of fixed assets

A decision to invest (capital decision) Rs. 100 crores in fixed assets would result in the increase of fixed capital

Importance of Financial Management

b

The amount of current assets

Cash, inventory, accounts receivables etc. are also affected by the financial management decisions

Importance of Financial Management

c

Amount of long term and short term funds

Financial management decisions will directly influence the availability of long term as well as short term funds in the business

It will affect the liquidity and profitability of the organization

Importance of Financial Management

d

Debt – equity ratio

Decisions regarding finance will determine the amount of debt, equity capital, preference capital etc.

Importance of Financial Management

e All items in the Profit and loss account

Financial management decisions will affect all the items in P/L account also.

Eg: if the organization is depending highly on borrowed funds, it may call for higher interest expense, which will result in poor profits.

Importance of Financial Management

a) The size and composition of fixed assets

b) The amount of current assets

c) Amount of long term and short term funds

d) Debt – equity ratio

e) All items in the Profit and loss account

Objectives of Financial Management

Objectives of Financial Management

1

Profit maximization

The financial management should ensure maximum return on investment to the shareholders

Objectives of Financial Management

2

Wealth maximization

The ultimate objective of decision makers must be to increase the wealth of shareholders or investors

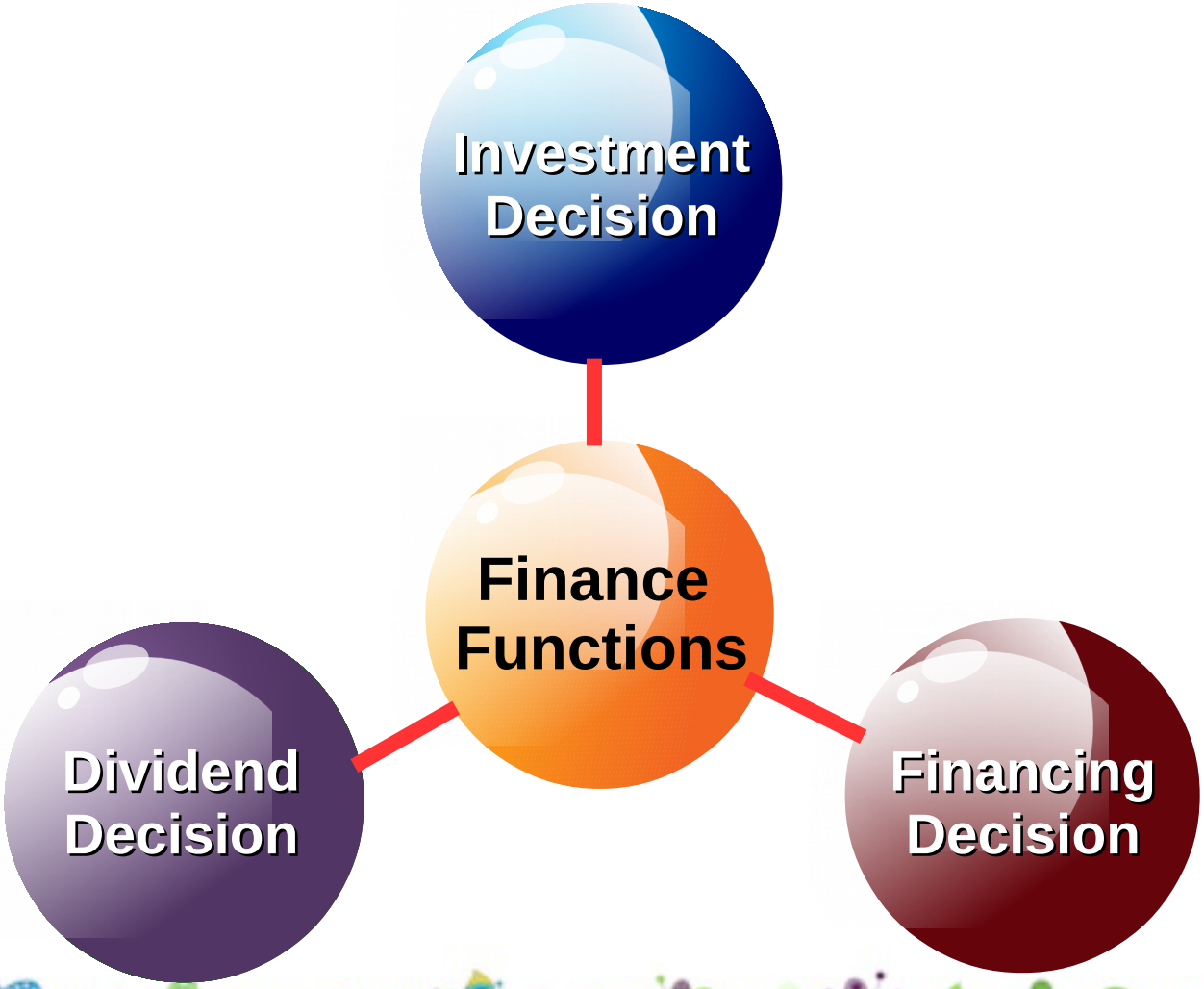
Wealth of owners = Number of shares held X market price per share

The financial management focuses on three major financial decision areas namely **investment, financing and dividend decisions**

They are collectively known as the finance functions of business

Finance Functions

(Financial Decisions)



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Investment Decision

Investment Decision

It is concerned with how firm's valuable funds are to be invested in various assets

Investment Decision

Long Term

Short Term

Investment Decision

a

Long term investment decisions
(capital budgeting decision)

E.g., Purchasing a new machine, opening a new branch etc.

Investment Decision

b

Short term investment decision (working capital decision)

Related to the day to day working of a business

E.g., Level of cash in hand, inventory etc.

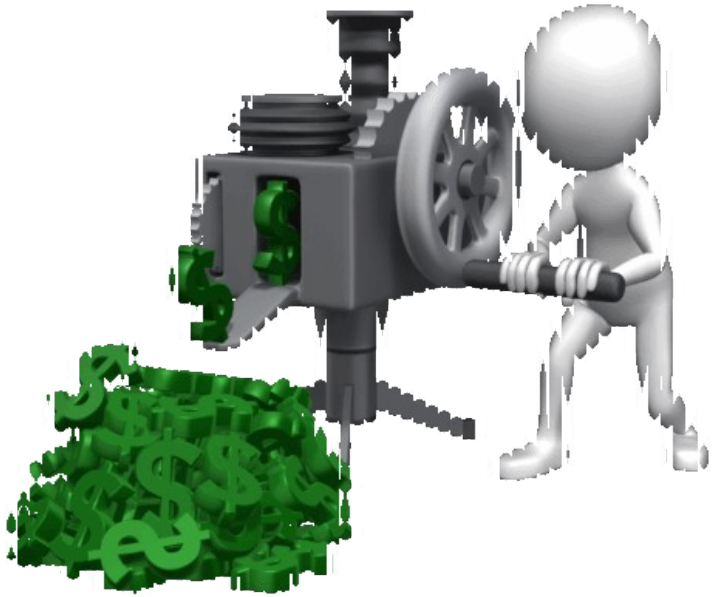
Factors affecting Capital Budgeting
(Investment Decision)

Factors Affecting Investment Decision

a

Cash flow of the project

The inflow and outflow of cash in the business should be considered before making capital budgeting decisions



Some projects will take a long period of time to start inflow of cash

Factors Affecting Investment Decision

b

The rate of return

While selecting a project, the rate of return must be considered

If two projects having 10% return and 15% return with almost equal risk, normally, the 2nd one may be selected

Factors Affecting Investment Decision

c

Investment criteria involved

Investment decisions must be based on certain capital budgeting techniques or calculations regarding the amount of investment, rate of return, interest rate, cash flow etc.

Factors affecting Investment Decision

a) Cash flow of the project

b) The rate of return

c) Investment criteria involved

Financing Decision

Financing Decision

It is concerned with the quantum of finance to be raised from various long term sources

They are shareholders' fund and borrowed fund such as shares, debentures, loans etc.

But a proper mix of the above securities is very much essential for maintaining a good capital structure of the company

Factors affecting Financing Decision

Factors affecting Financing Decision

a

Cost

Try to obtain the fund from cheaper sources

Factors affecting Financing Decision

b

Risk

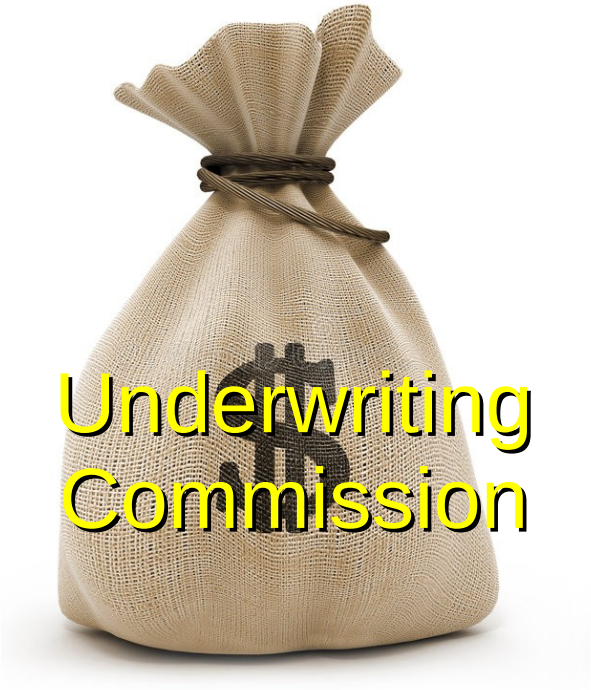
Risk factor in each source must be considered

Factors affecting Financing Decision

c

Flotation Cost

Cost of raising finance should be less



Factors affecting Financing Decision

d

Cash flow position

A stronger cash flow position recommends more debt financing

Factors affecting Financing Decision

e

Fixed Cost

If fixed operating costs like rent, insurance premium, salaries etc. are high, it is better to reduce debt financing having fixed interest burden

Factors affecting Financing Decision

f

Control

More dependence on owners fund will reduce control among the existing shareholders

Factors affecting Financing Decision

Capital Market Condition

During rising trends in capital market, it is easy to accumulate shareholders fund, otherwise better to depend on borrowed fund

Factors affecting Financing Decision

a) Cost

b) Risk

c) Flotation coast

d) Cash flow position

e) Fixed cost

f) Control

g) Capital market condition

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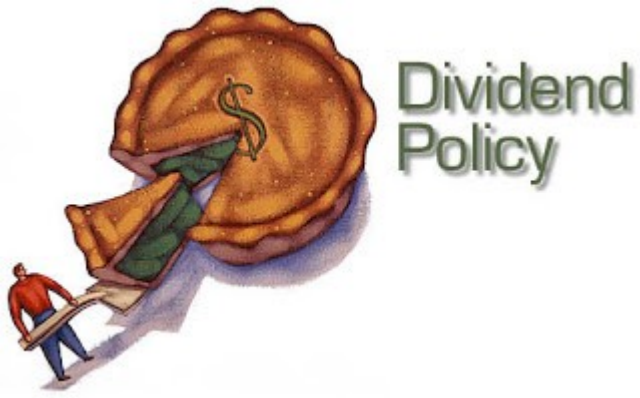
Dividend Decision

Dividend Decision

It is concerned with the disposal of profits

A portion of the profit is to be retained in the business for growth and expansion. That part of profit is called **retained earnings** and the rest of the profit is to be distributed to the shareholders in the form of **dividends.**



Here is the role of financial management that,
how much is to be retained and what would be distributed

Factors affecting

Dividend Decision

Factors affecting Dividend Decision

a

Amount of earnings

Dividend decision is always depend on the amount of profit during the current period

Factors affecting Dividend Decision

b

Stability of earnings

Stable earnings promotes higher dividend

Factors affecting Dividend Decision

c

Stability of dividend

It will improve the confidence of shareholders and higher reputation for the company

Factors affecting Dividend Decision

d

Growth opportunities

Fewer dividends may be given to the investors if the company is having growth and expansion projects

Factors affecting Dividend Decision

e

Cash flow position

Payment of dividend involves outflow of cash, therefore, enough cash must be available for the declaration of dividend

Factors affecting Dividend Decision

f

Shareholders' preference

Normally, shareholders want to get regular income from their investment, hence at least a minimum dividend may be distributed every year

Factors affecting Dividend Decision

g

Taxation Policy

If tax on dividend is higher, it is better to pay less by way of dividends.

But the dividends are free of tax in the hands of shareholders as a dividend distribution tax is levied on companies.

In the present tax policy, shareholders may demand higher dividend

Factors affecting Dividend Decision

h

Stock Market Reaction

Investors generally evaluate the companies on the basis of their dividend declaration status

Higher the rate of dividend gives a positive impact in the market

Factors affecting Dividend Decision

Access to Capital Market

Reputed companies generally have easy access to the capital market and therefore they may depend less on retained earnings to finance their growth

Reputed Company

So that they may declare high rate of dividend than small companies

Factors affecting Dividend Decision

j

Legal Constraints

While declaring dividends, the companies have to follow the restrictions laid down by Companies Act

Factors affecting Dividend Decision

k

Contractual Constraints

While granting loans to a company, sometimes the lender may impose certain restrictions on the payment of dividends in future

Factors affecting Dividend Decision

a) Amount of earnings

b) Stability of earnings

c) Stability of dividend

d) Growth opportunities

e) Cash flow position

f) Shareholders' preference

Factors affecting Dividend Decision

g) Taxation Policy

h) Stock Market Reaction

i) Access to Capital Market

j) Legal Constraints

k) Contractual Constraints

Financial Planning

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Financial Planning

When the process of planning employed in finance, it is called financial planning.

It involves the estimation, procurement, utilization and administration of funds.

Its objective is to ensure that enough funds are available at right time, but having no surplus funds

Important aspects of Financial Planning

a

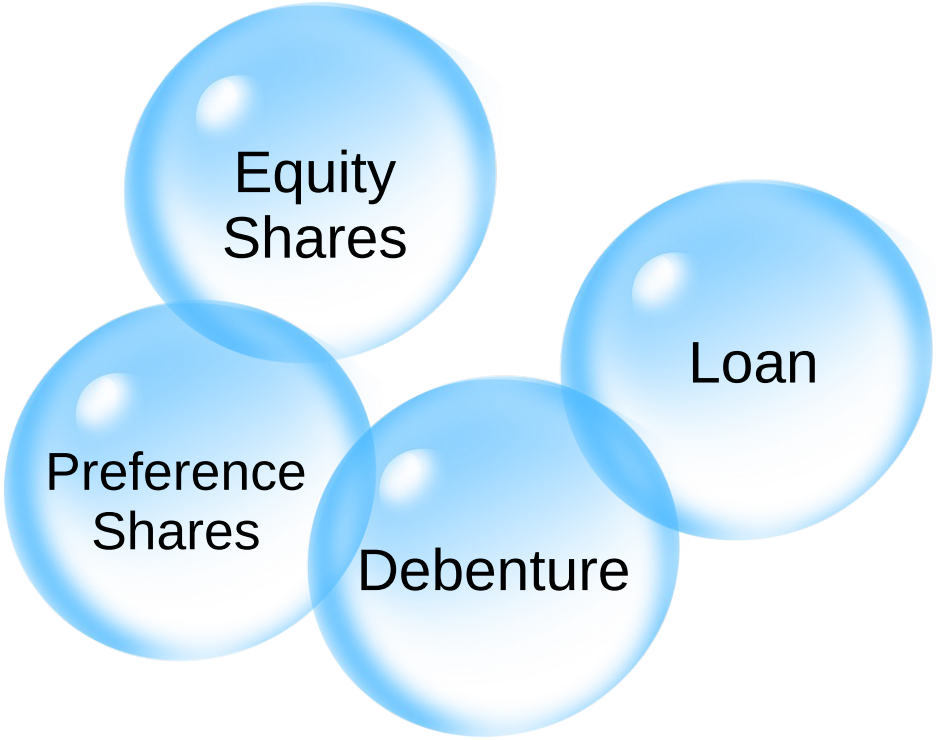
Estimation of Quantum of Finance

Total amount of finance required is to be determined

Important aspects of Financial Planning

b Determining the pattern of financing

Proportion of various securities to be issued is to be determined



Important aspects of Financial Planning

c Proper utilization of finance

Effective utilization of finance must be ensured through effective policies and programs

Types of

Financial Planning

Types of Financial Planning

a

Long term financial planning

It focuses on capital expenditure for long term growth and investment in business

Usually 3 to 5 years

Types of Financial Planning

b

Short term financial planning

It may be in the form of budget

Usually for a period of 1 year or less

Objectives of Financial Planning

Objectives of Financial Planning

1

To ensure availability of funds whenever required

It includes estimation of funds for long term and short terms needs of the organization

Objectives of Financial Planning

2

To ensure that the firm does not raise resources unnecessarily

it will help to minimize the loss due to idle fund in the organization

Importance of Financial Planning

Importance of Financial Planning

a

Forecasting

It helps the organization to foresee the future financial requirements in advance

Importance of Financial Planning

b

Avoiding uncertainties

Helps in meeting unexpected situations by arranging necessary funds

Importance of Financial Planning

c

Coordination

Helps to coordinate the activities of all departments in the organization by allotting them necessary funds in time

Importance of Financial Planning

d

Reduces wastages

Through proper planning about the financial requirements helps to reduce wastages and duplication of efforts

Importance of Financial Planning

e

Easy evaluation

It helps to evaluate the actual performance of the organization based on the plans formulated in advance

Importance of Financial Planning

1. Forecasting
2. Avoiding uncertainties
3. Coordination
4. Reduces wastages
5. Easy evaluation

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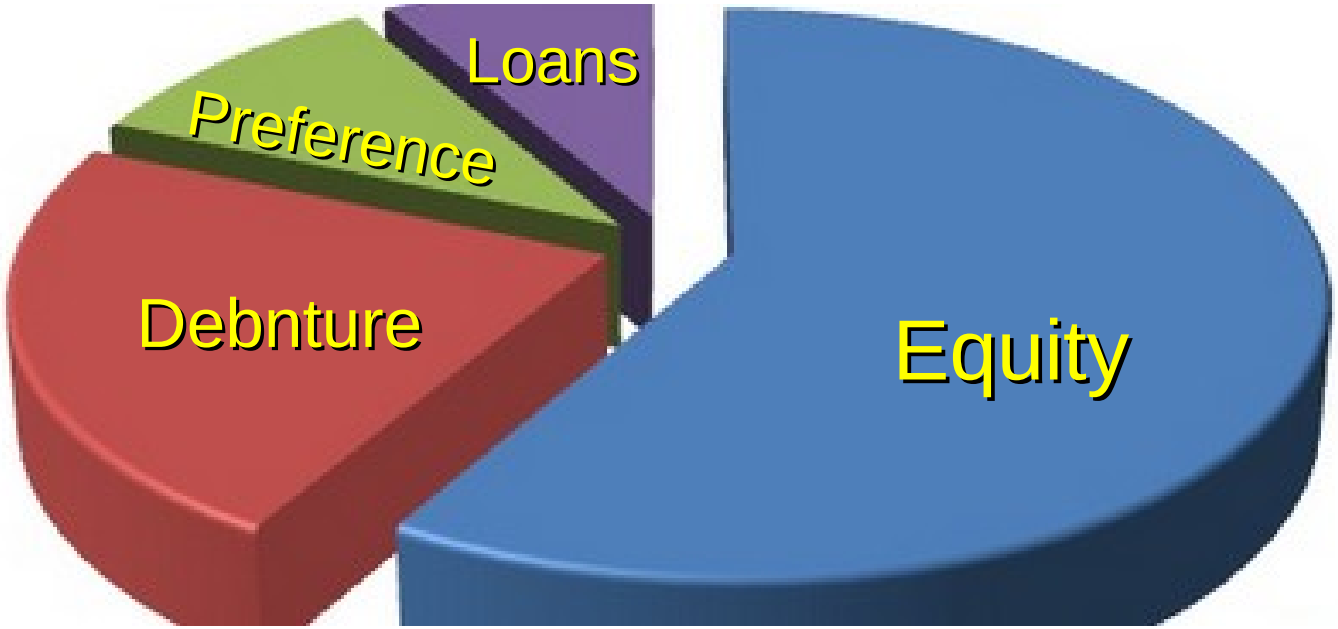
Capital Structure

Capital Structure

Capital structure refers to the mix or composition of long term sources of funds such as equity share capital, preference share capital, debentures, long term loans and reserves and surplus

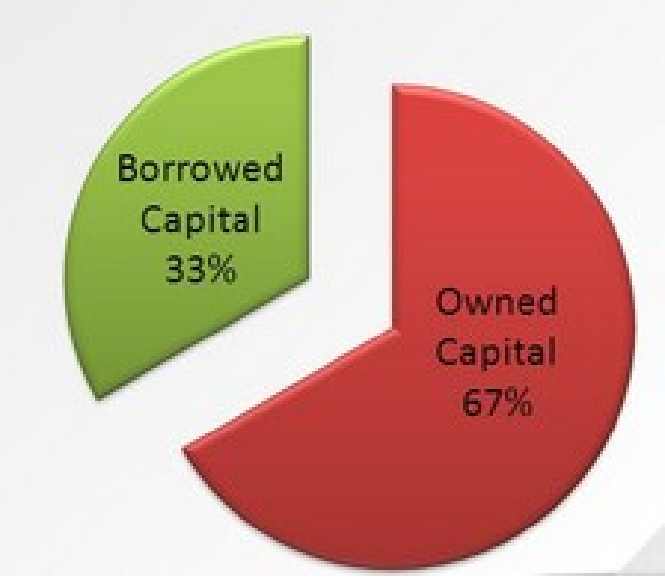


Capital Structure

It refers to the proportion of borrowed funds to owner's funds

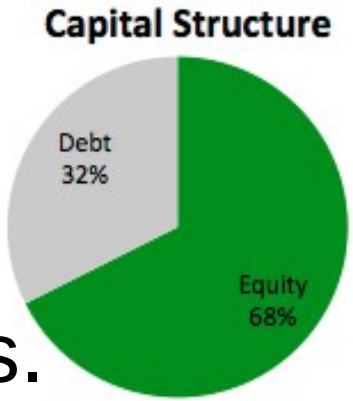
(*It is a mix between owners' funds and borrowed funds)*

Owners' funds are called **equity** and borrowed funds as **debt**



Capital Structure

The capital structure of a company consists any of the following forms:

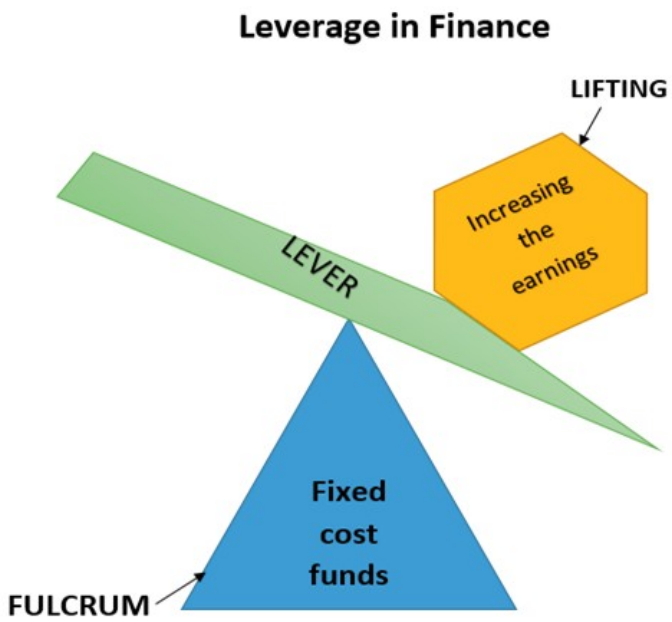


1. Equity shares only.
2. Equity shares and preference shares.
3. Equity shares and debentures.
4. Equity shares, preference shares and debentures.
5. Equity, Preference, debentures and long term loans.

Financial Leverage

Financial Leverage

The proportion of debt in the capital structure is called financial leverage or capital gearing or trading on equity



When the proportion of owners' funds in capital structure is very small, it is said to be high geared, whereas, if borrowed fund is less than equities, it is called a low geared company

Financial Leverage

As the financial leverage increases (highly geared) the cost of funds declined and therefore more earnings per share, but the financial risks increases

Financial Leverage

The impact of financial leverage on profitability:

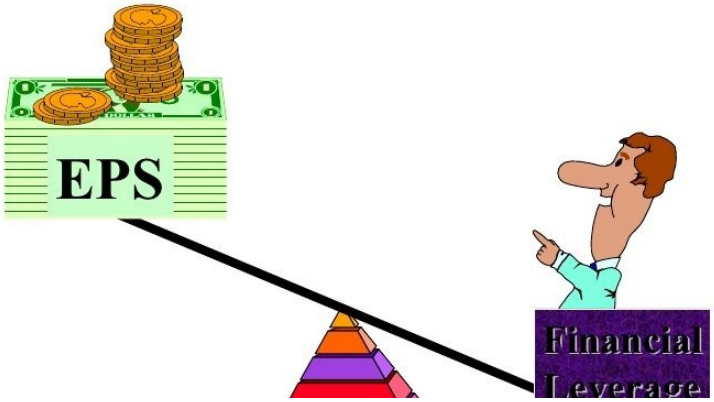
Descriptions	Company A	Company B	Company C
No. Equity shares @ Rs.10	30000	20000	10000
Equity Capital	300000	200000	100000
10% Debentures (borrowed fund)	NIL	100000	200000
Total Capital	300000	300000	300000
Profit @ 20% on investment	60000	60000	60000
Interest on debentures	NIL	10000	20000
Net Profit	**60000**	**50000**	**40000**
Earnings per share	2	2.5	4
Leverage	**Unlevered**	**Low**	**High**

Note: Income tax on profit is ignored

Trading on Equity

Trading on equity

It refers to the use of fixed income securities such as debentures and preference capital in the capital structure so as to increase the return on equity capital



Equity share holders get additional profits with the help of employing others fund.

It is also known as financial leverage or capital gearing

Trading on equity

Eg: A company raises Rs.50,000 through equity shares and earns a profit of Rs.5,000. The rate of return is 10%.

On the other hand, if the company raises Rs.40,000 by way of 6% debentures and Rs.10,000 through equity shares, the rate of return to equity shareholders is increased to 26% as follows:

Total Investment 40000 +10000	= 50,000
Total Profit	= 5,000
Interest on debentures 40000 * 6%	= 2,400
Balance of Profit to equity shareholders (5000-2400)	= 2,600
Rate of return on equity share capital (2600/10000*100)	**= 26%**

Factors Affecting the Choice of Capital Structure

Factors affecting Capital Structure

1 Cash flow ability for servicing the debt

Servicing debts means paying interest and principal amount of loans as and when it is due for payment

If a debt is to be included in the capital structure, the company should estimate the future cash flow to ensure the coverage

Factors affecting Capital Structure

2

Interest coverage ratio

ICR refers to the number of times, earnings before interest and taxes (EBIT) covers the interest obligation

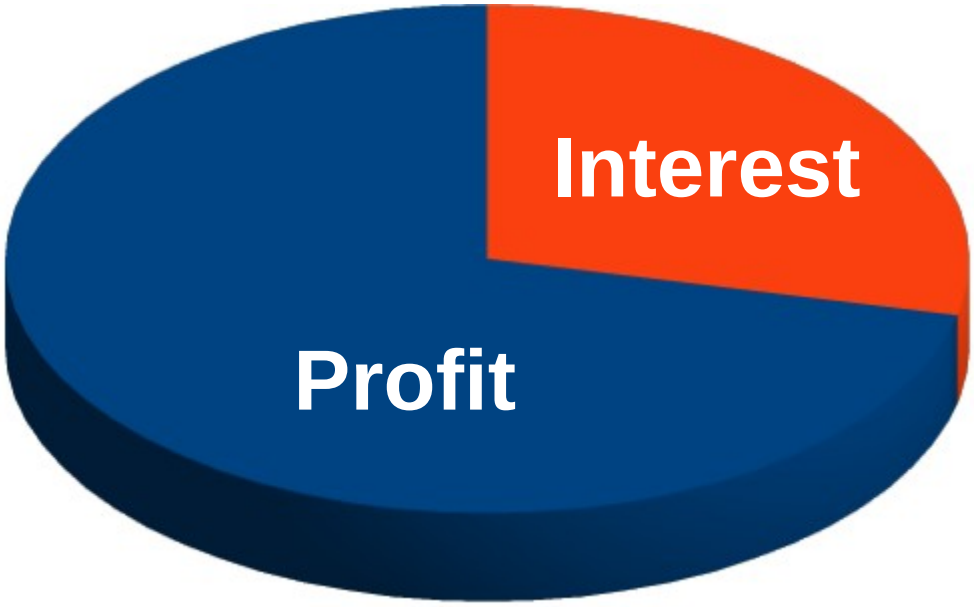
$$ICR = \frac{EBIT}{Interest}$$

Higher the ratio means lower the risk for the company to pay off interest in time

Factors affecting Capital Structure

3 Debt Service Coverage Ratio (DSCR)

The cash profits generated from the operations must be enough to service the debts and preference share capital



Factors affecting Capital Structure

4

Return on Investment (ROI)

If ROI is higher than rate of interest for debt, borrowed fund can be increased in capital structure, otherwise, increase in equity portion is good

Factors affecting Capital Structure

5

Cost of debt

If the firm is able to borrow at a lower rate, it may prefer more debt than equity in capital structure

Factors affecting Capital Structure

6

Tax rate

Income tax liability can be reduced by employing borrowed funds in capital structure, as the interest on debt is a deductible expense

Factors affecting Capital Structure

7

Cost of Equity

When a company increases debt in their capital structure, the financial risk faced by the equity shareholders may increase, consequently their desired rate of return may increase. So that the company cannot use debt beyond a point

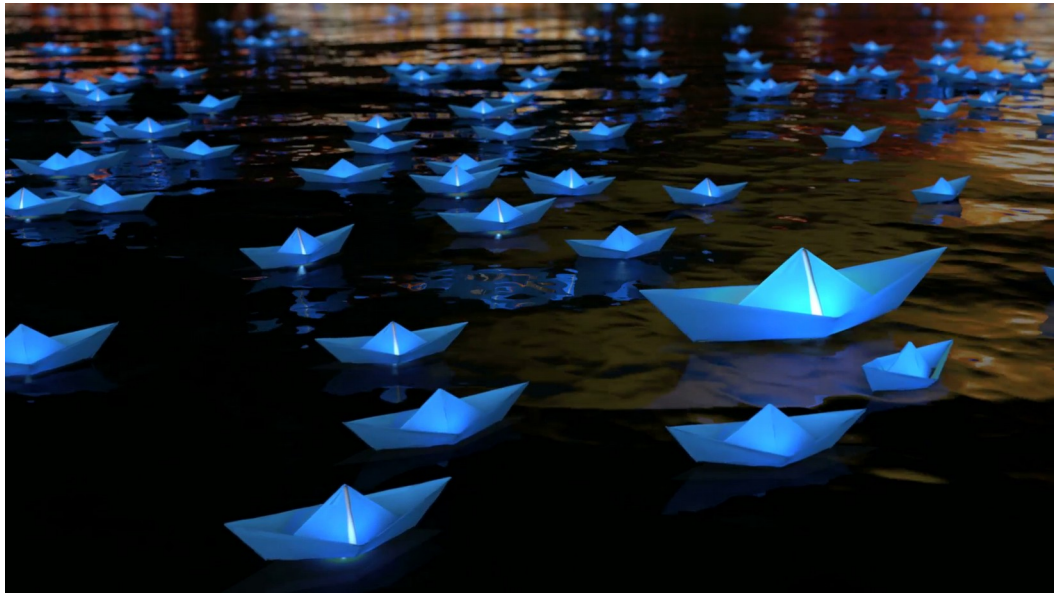
Factors affecting Capital Structure

8

Floatation cost

It is the cost incurred for floating (issue) securities such as brokerage, underwriting commission etc.

It is generally less in case of debts



Factors affecting Capital Structure

9

Risk Consideration

A business has two types of risks; they are financial risk (to pay interest, preference dividend, repayment of debt etc.) and business risk (operating risk).

It must be considered while choosing a suitable capital structure

Factors affecting Capital Structure

10

Flexibility

The capital structure should be capable of being adjusted according to the needs of changing conditions

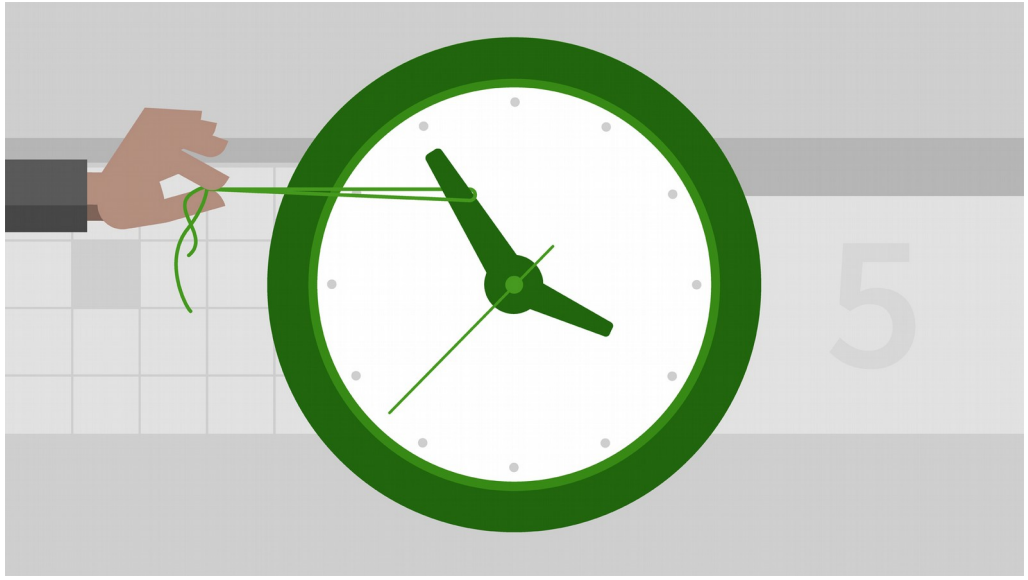
To maintain flexibility, the company should maintain some borrowing power to take care of unforeseen circumstances

Factors affecting Capital Structure

11

Control

If the control of the management is to be retained, debt financing is recommended for raising additional fund



Factors affecting Capital Structure

12

Regulatory Framework

Rules and regulations framed by SEBI etc. must be considered while choosing a capital structure

Factors affecting Capital Structure

13

Stock Market Conditions

During depression in capital market, investors will prefer fixed interest bearing securities for safety and hence it is not advisable to issue shares that time

In a booming situation, issue of share will be more preferable

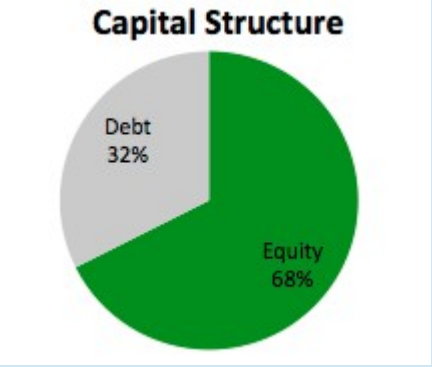
Factors affecting Capital Structure

14 Capital Structure of other Companies

Capital structure followed by other companies in the same industry may be adopted by considering whether they are in conformity with the industry norms or not

Factors affecting Capital Structure

1. Cash flow ability for servicing the debt
2. Interest coverage ratio
3. Debt Service Coverage Ratio (DSCR)
4. Return on Investment (ROI)
5. Cost of debt
6. Tax rate
7. Cost of Equity



Factors affecting Capital Structure

8.Floatation cost

9.Risk Consideration

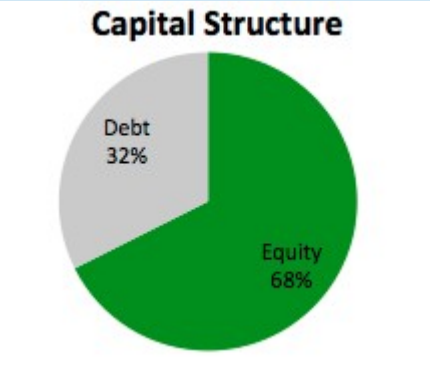
10.Flexibility

11.Control

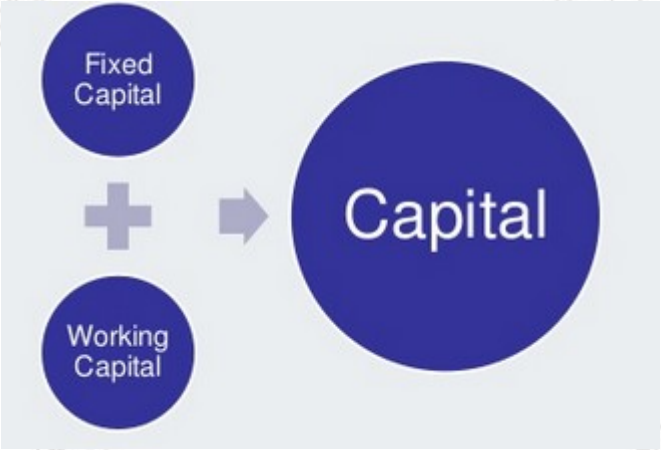
12.Regulatory Framework

13.Stock Market Conditions

14.Capital Structure of other Companies



Fixed Capital & Working Capital



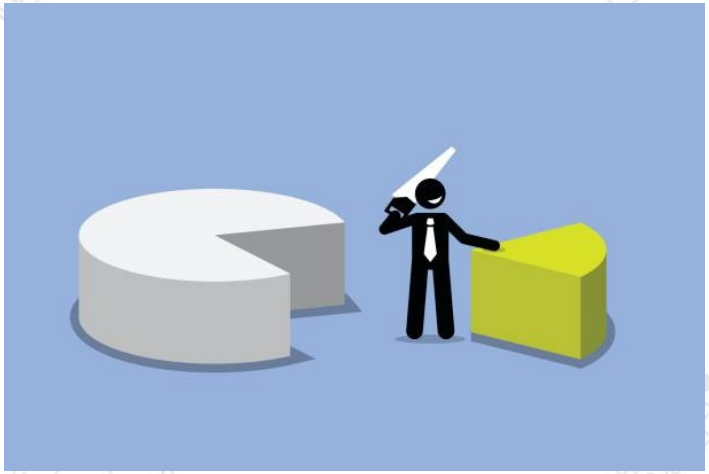
Fixed Capital

Fixed Capital

Fixed capital represents a long term investment which needed to acquire fixed assets like land and building, plant and machinery, vehicles etc., benefits of which are expected to be received over a number of years in future

Management of Fixed Capital

It refers to the allocation of firm's capital to different projects or assets which will have a long term implications in the business



Importance of Management of Fixed Capital

Importance of Management of Fixed Capital

1

Long term growth

This capital is invested in fixed assets and long term projects, therefore, it will affect the future prospects of business

Importance of Management of Fixed Capital

2

Large amount of funds involved

A major portion of capital may be blocked in this areas, hence careful planning and detailed analysis is very essential in this segment

Importance of Management of Fixed Capital

3

High risk

Investment decisions involving huge capital outlay influence the overall performance of the business

Importance of Management of Fixed Capital

4

Irreversible decision

Once the decision to acquire a permanent asset is taken, it becomes very difficult to reverse that decision

It is possible but with huge losses

Importance of Management of Fixed Capital

1. Long term growth
2. Large amount of funds involved
3. High risk
4. Irreversible decision

Ajith Kanthi Wayanad
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Factors Affecting the Requirement of Fixed Capital

Factors Affecting the Requirement of Fixed Capital

1

Nature of Business

The nature and character of business determine how much fixed capital is required

In a manufacturing concern fixed assets require huge investments

Factors Affecting the Requirement of Fixed Capital

2

Scale of Operations

Large scale business generally require huge investments in fixed capital than a small scale business organization

Factors Affecting the Requirement of Fixed Capital

3

Choice of technique

Highly mechanized and automated industries require large amount of fixed capital

Factors Affecting the Requirement of Fixed Capital

4

Technology up gradation

Assets in certain industries become obsolete sooner, this requires replacement faster which will demand more fixed capital

Eg: computers, mobile phone manufacturing equipments etc.

Factors Affecting the Requirement of Fixed Capital

5

Growth prospects

Higher investment in fixed capital is necessary, if the organization is in the way of growth and expansion

Factors Affecting the Requirement of Fixed Capital

6

Diversification

When a firm diverts its operations to new segments, higher fixed capital requirement arises

Eg: ITC Company diverted its business to note books manufacturing along with their traditional item of cigarettes

7

Method of acquiring fixed assets (financing alternatives)

If it is on hire purchase or lease system, less amount of investment is required for cash purchase

8

Collaboration

By collaborating with other firms, the requirement of fixed capital can be reduced

Eg: Establishment of ATM counters by cooperative banks by collaborating with certain scheduled banks

Factors affecting Fixed Capital

1. Nature of Business
2. Scale of Operations
3. Choice of technique
4. Technology up gradation
5. Growth prospects
6. Diversification
7. Method of acquiring fixed assets
8. Collaboration

Working Capital

Working Capital

Working capital is that part of capital required for investing in short term or current assets like inventory (raw materials, work in progress and finished goods), bills receivables, sundry debtors, cash required for day to day affairs like salaries, wages, rent, etc.

Working Capital

A business concern must neither have excessive nor inadequate working capital

Both the situations are dangerous

Working Capital

There are two concepts of defining working capital:

1. **Gross working capital**
   = Total investment in current assets

2. **Net working capital**
   = Current assets – Current Liabilities

Factors Affecting Working Capital Requirements

Factors Affecting Working Capital Requirements

1

Nature of business

Concerns which do not keep very high stock of finished goods and sells on cash basis can manage with less working capital

Factors Affecting Working Capital Requirements

2

Scale of Operations

Generally big enterprises have to keep higher working capital

Factors Affecting Working Capital Requirements

3

Business Cycle

In boom period, the production and sales will be larger and hence huge amount of working capital is required

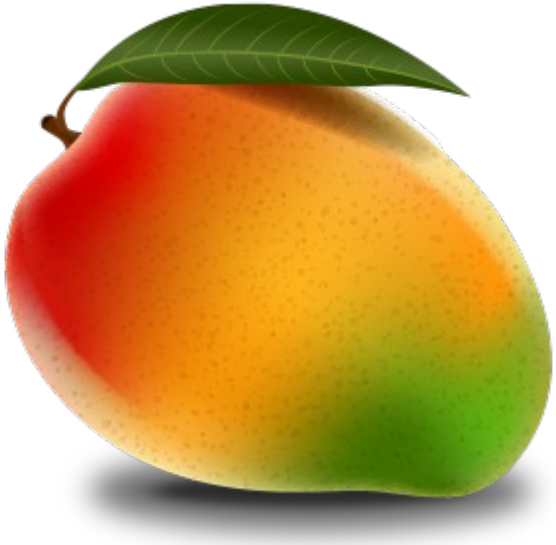
But in case of depression, it will be less

Factors Affecting Working Capital Requirements

4

Seasonal Factors

Industries that produce and sell seasonal goods require large amount of working capital

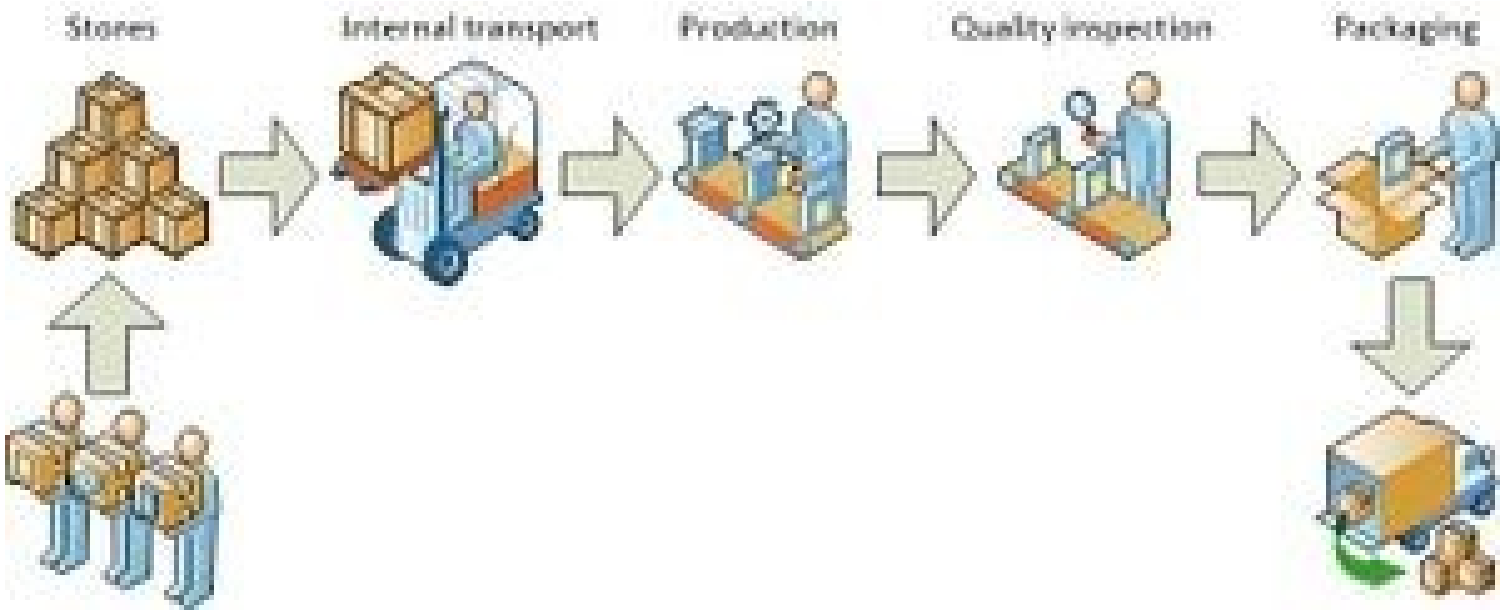


Factors Affecting Working Capital Requirements

5

Production cycle

Longer the period of manufacture, larger is the amount of working capital required



Factors Affecting Working Capital Requirements

6

Credit allowed

A liberal credit policy results in higher amount of debtors and thereby more working capital requirement

Factors Affecting Working Capital Requirements

7

Credit availed

If a business gets credit facility from its suppliers for goods, lesser would be the working capital requirement

Factors Affecting Working Capital Requirements

8

Operating efficiency

If cash, debtors and inventories are efficiently managed, working capital requirement can be reduced

Factors Affecting Working Capital Requirements

9

Availability of raw materials

If raw materials are available regularly without any shortage, less working capital is needed

Factors Affecting Working Capital Requirements

10

Growth prospects

If a firm is growing fast, it will require large amount of working capital to meet higher production and sales

11

Level of competition

In case the competition is high, more shall be the stock of finished goods, this increases working capital requirement

12

Inflation

Huge amount of working capital is needed at the time of inflation (price rises) to maintain a constant volume of production and sales

Factors affecting Working Capital

1. Nature of business
2. Scale of Operations
3. Business Cycle
4. Seasonal Factors
5. Production cycle
6. Credit allowed

Factors affecting Working Capital

7. Credit availed
8. Operating efficiency
9. Availability of raw materials
10. Growth prospects
11. Level of competition
12. Inflation

Prepared by:

Ajith Kanthi @ Ajith P P

SKMJ HSS Kalpetta

Wayanad, Kerala

Ph: 9446162771, 7907712665

ajithkanthi@gmail.com

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END
BEST ANIMATIONS